The Importance of Hedge Funds in Emerging Markets: An Analysis by PineBridge Investments

Matthew Denning and Samantha Rosenstock, both of whom are Vice Presidents, Senior Research Analysts within PineBridge Investments’ Hedge Fund Solutions Group, argue that investors seeking emerging markets exposure should consider an active hedge fund strategy to complement their private equity portfolios. PineBridge Investments manages US$67.3 billion in assets, as of 31 December 2011, for institutional and individual clients across an extensive platform of listed equity, fixed income, private equity, and hedge capabilities.

Introduction

Since the financial crisis of 2008, it has been easy to make the claim that emerging markets offer only minimal diversification benefits for investors. During the crisis, country-specific fundamentals became a secondary concern, as global financial markets sold-off indiscriminately. As correlations across global markets converged during the crisis, market observers concluded that emerging markets provided little to no diversification benefits for investors’ portfolios.

However, we would argue that if investors deconstruct the emerging markets opportunity set and consider the policy and growth differentials that are prevalent across these economies, then diversification benefits would become apparent. Further, we make the case that due to the dynamic nature of emerging markets, for investors willing to assume the increased risks of emerging markets and alternative investment strategies, an active hedge fund strategy is a better approach than long-only strategies and can complement private equity investments in emerging markets. To make our argument, we provide an overview of the opportunity set in emerging markets from both a top-down and bottom-up perspective.

Dispersion in Emerging Markets Policy and Growth

Looking at emerging markets from a top-down perspective, we see economies that provide a fertile ground for macro trading. While growth prospects in developed markets are more constrained, emerging market fundamentals are diverse across various countries and regions. Several emerging market economies still have favorable debt to GDP ratios compared to developed market economies as shown in Exhibit 1. Additionally, projected growth in emerging market economies is much more robust relative to developed markets, which is conducive to investment opportunities. Further, while most developed market central banks have almost entirely exhausted their traditional policy tools, in our view, this is not the case for emerging markets in aggregate, where interest rates remain dispersed as shown in Exhibit 2. As a result, emerging market central banks have more room to support growth and weather economic shocks.

Exhibit 1: Debt/GDP and Average Yearly Projected Growth Rates (%)

![Exhibit 1: Debt/GDP and Average Yearly Projected Growth Rates (%)](chart)

Source: IMF Fiscal Monitor September 2011.

1 Projected growth rates are the simple arithmetic average of the IMF’s projected growth rates for each country over the next five years.
decelerations. Given the varied fundamental outlooks and significant degrees of freedom to enact traditional monetary policy, we believe that there are ample macro opportunities in emerging market rates and currencies.

**Deconstructing the Emerging Market Equity Opportunity Set**

From a bottom-up perspective, we can also see the diversification benefits of emerging markets if we deconstruct the investment landscape. We focused on Brazil as a case study, but similar results can be found across different emerging market economies and regions. We began our analysis by dividing the Brazilian equity markets into three buckets based on liquidity levels as measured by daily trading volume:

- Bucket A consisted of securities that traded over US$10 million per day;
- Bucket B consisted of securities that traded from US$5 million to US$10 million per day; and,
- Bucket C consisted of securities that traded from US$5 million to US$1 million per day.

We ran the correlations of these three buckets to both global and U.S. equity market indices for the period of January 2009 to December 2011, based on monthly data as shown in Exhibit 3. We found that the correlations in the highest liquidity bucket, Bucket A, ranged from 0.68 to 0.74 to global and U.S. equity benchmarks. Meanwhile, correlations in the other two equity buckets were lower, ranging from 0.5 to 0.65. We found similar results when we ran the correlations from February 2005 to December 2011 as shown in Exhibit 4. While the lower correlations in Buckets B and C were not overtly drastic, they were significant enough for us to draw the conclusion that investors can find diversification benefits in emerging market equities. However, in order to achieve diversification, investors need to look beyond the typical large capitalization equity names, which are represented by Bucket A in our example, that yield the highest beta exposure and leave the true alpha source unscathed.

**A Hedged Approach**

While it may be the case that emerging markets show ample growth and policy differentials and possess uncorrelated investment opportunities, when we look beyond the aggregate indices, one question still remains: In gaining emerging market exposure, why should investors utilize hedge fund strategies as a complement to private equity rather than long-only investments? To address this question, we first outline the factors that can drive hedge fund investments to outperform long-only strategies and then discuss complementary value to private equity.

In analyzing which investment vehicle is optimal to approaching emerging markets, it is critical that we consider the current global economic conditions. When we survey the economic standing of regions around the world, we see continued pressures in both developed and emerging markets. Europe still faces significant hurdles in dealing with its sovereign debt crisis and banking issues, while the United States still faces a long road towards fiscal reform. In Asia, Japan is only beginning to recover from the disastrous effects of the tsunami last year. On the emerging markets side, Brazil and China also face the pressure of managing their economies against a “hard landing” scenario. With
such macroeconomic headwinds still prevalent, it is difficult to envision a sustained bull-run trend in emerging markets, where arguably long-only investments would outperform. Hedge fund strategies, which are tactical and dynamic in nature through their active portfolio rotations, can be more responsive to this type of environment and outperform.

Secondly, as we have shown, emerging market economies have dispersion in growth and policy, and possess diversified opportunities within their own local markets. However, in order to capitalize on these opportunities, we view as fundamental the ability to go both long and short in emerging markets. From a macro perspective, the dispersions in growth and policy give hedge funds the capacity to pair a long investment in a given country against a short investment in another, which can be further paired across different asset classes. From a micro perspective, taking advantage of the uncorrelated opportunities that exist within local markets also requires the capacity to go long and short within an asset class. Investing in these markets through a long-biased vehicle may only provide beta exposure and leave untouched the plethora of opportunities that exist across the different regions, sectors and liquidity spheres in emerging markets.

Moreover, a pure beta allocation to emerging markets can leave investors significantly exposed to large drawdown risks. For investors with absolute return targets, such losses are unbearable if they are to meet their longer-term funding commitments. We contend that an active hedge fund approach to emerging markets investing can help mitigate some of this potential risk. During the depths of the financial crisis that started in late 2007, as markets came under pressure, hedge fund strategies, as represented by the Dow Jones Credit Suisse Emerging Markets Hedge Fund Index, managed to avert losses much better than passive emerging markets bonds or equities. As can be seen from Exhibit 5, from October 2007 to February 2009 emerging market hedge funds incurred a drawdown of 32.3% while emerging market equities and bonds lost 62.7% and 64.2% respectively, during this time period. The capacity of hedge fund investments to mitigate downside risks relative to long-only investments was also observable during the second half 2011. For the period of January 2006 to December 2011, emerging market-focused hedge fund strategies achieved an annualized Sharpe ratio of 0.45, while emerging markets equities and bonds achieved Sharpe ratios of 0.16 and 0.01 respectively, demonstrating hedge funds’ capacity to produce more consistent returns with lower volatility.

We contend that hedge fund strategies also have the potential to provide incremental benefits to existing private equity portfolios in emerging markets. As several emerging markets still have underdeveloped private sectors,
an investment through a hedge fund vehicle can provide investors with an expanded investment universe through exposure to the public markets. Hedge fund strategies, which can invest in a wide array of asset classes such as currencies, fixed income, and commodities in addition to corporate securities, can provide diversification, thereby increasing the potential to capitalize on the opportunity set in emerging markets.

Also, for investors with existing private equity commitments, hedge fund investments have the ability to provide adaptive exposure to changing economic regimes. As we have noted, significant macro risk factors remain prevalent in the global economy and emerging markets are not immune to volatility. In an increased volatility environment, hedge funds tend to reduce overall exposures in order to preserve investors’ capital—a strategy not easily executed with private equity funds. Additionally, hedge fund strategies also have the ability to quickly change a portfolio’s composition so that it has the potential to benefit from a highly dynamic environment.

Lastly, we note that the capacity of hedge fund strategies to be complimentary to private equity investments in emerging markets comes as a function of achieving a greater liquidity profile for investors. Committed capital to a private equity investment in emerging markets may come with an extended holding period that can span across several years. Even though hedge fund investments have extended holding periods relative to long-only investments, they may still offer private equity investors liquidity value. This can help bridge the gap in medium-term funding needs.

In summary, a hedge fund approach should be considered by those investors that are interested in emerging markets and willing to assume the higher complexity and longer holding periods associated with alternative investments. We view the ability of hedge fund strategies to outperform long-only vehicles in the current environment, or more generally an environment in which there is not a steady bull market trend, as a direct function of their tactical nature, long and short ability, and dynamic portfolio rotation capacities. Further, we believe hedge fund investments can complement private equity by enabling access to a broader investment opportunity set, increasing exposure flexibility, and amplifying portfolio liquidity. Collectively, these attributes give hedge fund strategies the potential to deliver unique diversified exposure and optimal risk-adjusted returns in emerging markets.

Matthew Denning joined the firm in 2002 and is responsible for hedge fund manager research and due diligence. Mr. Denning focuses primarily on equity long / short hedge funds, monitoring existing equity hedge fund relationships for the firm and sourcing new potential investments. His investment experience began in 1999 and includes Sanford Bernstein and Putnam Investments. Mr. Denning received a BS in Business from the Marriott School of Management at Brigham Young University. He holds the Financial Risk Manager (FRM) designation.

Samantha Rosenstock joined the firm in September 2006 and is responsible for hedge fund manager research and due diligence. Focusing on CTA, global macro and commodity strategies, Ms. Rosenstock identifies prospective hedge fund investments and monitors existing hedge fund investments for the fund of fund portfolios. Prior to joining the firm, Ms. Rosenstock was a Senior Analyst at Ivy Asset Management and spent the first five years of her career at R.G. Niederhoffer Capital Management. Ms. Rosenstock holds a BA in Mathematics from Wesleyan University.